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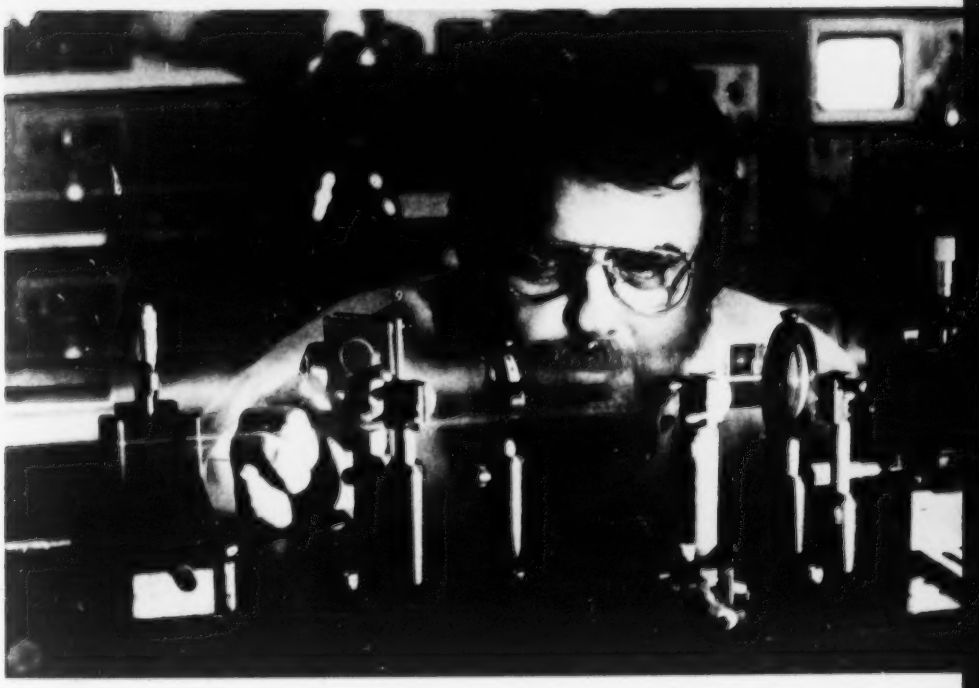

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Editor's Note

Another three months have rolled by, so it's time again for our regular quarterly review of the outlook for major industries, which you will find in the center (colored) section of this issue. In addition, we offer an article on the increased mobility of capital, a little appreciated development that has broad implications for some of the theoretical foundations of economic analysis. This article, incidentally, builds on some of the ideas developed by Alan Greenspan in his piece on product downsizing that was excerpted in the September 1991 *Economic Times*.

We also have an update on the painful transition being made by the Polish economy to a market system. Our faithful Colloquium panel takes a look at one important aspect of the recent financial turmoil in Europe. And of course, our regular Stat File and Crystal Ball features on the economic outlook are included.

Our cover illustration this month comes to us courtesy of AT&T. It shows a Bell Labs researcher demonstrating a laser that could be applied to switching and computing technology. Finally, note that our maxim of the month was selected with the forthcoming elections in mind.

Ed Fiedler

Maxim of the Month:

You can't learn too soon that the most useful thing about a principle is that it can always be sacrificed to expediency.

W. Somerset Maugham

Cruelty and Anger

Any friends who ask me about politics these days usually don't get an answer. If they persist, they might get a snarl and a mumbled cliche such as "a plague on both their houses" or "we need less politics and less government, not more."

My reluctance even to comment on politics has been overcome, however, by a recent outrageous example of too much politics/government: a *New York Times* story about the Gowanda (NY) Psychiatric Center. In a massive facility that once held 3,710 patients, the state now cares for just 14 with a staff of 44 psychiatrists, therapists, admissions officers and others, at a cost of about $200,000 per patient per year. The politics that is perpetuating this insanity is the pressure being exerted on the state legislature by community leaders, local lawmakers and unions to preserve the jobs at the facility, and the unwillingness of the legislature to override that pressure.

Some of my friends will dismiss Gowanda as a bizarre aberration unrepresentative of most government activities. Not so, in my view. Although I readily agree that this is an egregious example, I'm afraid it's all too representative. Consider the postal service, public schools, the police, welfare, toxic waste disposal, farm subsidies, student loans, public housing, import quotas, and cable TV regulation; almost every item on that list will, I'm sure, bring to mind instances of fraud, venality, inefficiency, waste, or mismanagement created by government.

Does government always fail? Certainly not. Sometimes it functions rather well. Meat inspection seems to work effectively, for example. Some public schools are very proficient. I've always regarded the Census Bureau as a "good bureaucracy;" the IRS, too (with qualifications). But those are not the general rule; too often, government is ineffective and harmful rather than helpful.

Does the private sector always do things right? No, indeed. But when the endeavors of individuals and private institutions get messed up, as happens frequently enough, the damage that's done is more often limited in size, confined to the parties directly involved, and cut off sooner than with public activities—not always but more often.

The reason I'm down on politics, then, is not that the private sector is free of failure, but because the costs of failure are substantially greater in public activities. The essential reason for this, I believe, is the way our political system creates incentives not to serve the public but rather to preserve the jobs of politicians and bureaucrats, and thus to push the system still further in the direction of bigger and less productive government.

If, however, all that was involved here was a waste of tax money, this story would not warrant any anger. But it's not just that. The point is that the $3 million being spent each year to care for 14 patients in Gowanda could otherwise be used for community residences—widely regarded to be a more humane and more effective method of treating most mentally disturbed people—that would take care of more than 100 of the mentally ill who are now living a tormented, painful existence on the streets of our major cities.

Thus, the politics of saving jobs in Gowanda is not just wasteful. It is cruel. And that *is* worth getting angry about.

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Colloquium: A Single Currency for Europe?

BACKGROUND

Europe's financial markets have been in turmoil recently. First, the British pound and the Italian lira were suspended, and the Spanish peseta devalued, from their previous relationships within the exchange rate mechanism. And then the 51 to 49 margin by which French voters approved the European union (Maastricht) treaty seemed too narrow to portend eventual approval of the union throughout Europe. These events have raised serious doubts that the final monetary goal of the union—a single currency by the end of the century—will be reached.

QUESTION:

How important is a single currency to Europe? Do the promised gains in efficiency from the union depend upon a common currency and a common monetary policy? Or can most of the benefits be realized simply by removing all barriers and harmonizing all regulations, even though each nation keeps its own currency?

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Gail D. Fosler, Vice President and Chief Economist, The Conference Board; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

James Tobin
Yale University

The Maastricht agreement mistakenly made a single European currency (ecu) the principal symbol of the "European idea." The ecu is certainly not indispensable for realizing the benefits of a borderless regional economy. And it's premature. The twelve nations are insufficiently compatible in institutions, circumstances and priorities to surrender national monetary independence and freedom to adjust to shocks by movements in exchange rates. Someday, maybe, but not this century.

Gail D. Fosler
The Conference Board

Europe should create a common currency as well as maintain its present national currencies. Even if all regulations and barriers to exchange were eliminated, global competitive pressures would create large differences in economic performance among the countries. A common currency would encourage region-wide trade by eliminating exchange inefficiencies while individual currencies would signal country differences and encourage policy efficiency. The United States does not have such an option to address its regional economic problems.

Isabel Sawhill
The Urban Institute

As long as countries follow different economic policies in pursuit of national goals, exchange rates cannot be kept within narrow bands. This is why the exchange rate mechanism broke down and why we're likely to see a common European currency soon. Yes, many of the same benefits can be achieved by reducing trade barriers, but not all. Imagine what it would be like if U.S. businesses had to worry constantly about the value of the California yin-yen relative to the Florida orangemark.

Lyle E. Gramley
Mortgage Bankers Association

The benefits to economic welfare in Europe associated with a common currency are not trivial, but they pale by comparison with those stemming from complete removal of barriers to trade and finance. Nonetheless, the currency turmoil in Europe these past few weeks is of profound significance, because it indicates a lack of political will—particularly on the part of Germany—to adopt macroeconomic policies that are in the broader interests of all European countries. Can disharmony with regard to trade and financial policies be far behind?

Capital Mobility: Challenges for Business and Government

by Richard B. McKenzie and Dwight R. Lee

One of the most profound changes in American business during the past decade and a half is that it is no longer just American. Neither is Japanese business simply Japanese, nor German business, German. Most lines of business activity are virtually unfettered by geopolitical boundaries.

We submit that democratic capitalism (and socialism) has changed dramatically—and continues to evolve—because capital has gone through a metamorphosis of major proportions. Not too many decades ago, capital was epitomized by steel and concrete, and huge factories. Belching smokestacks were capitalism at its finest. Capital was tied to its physical location: by virtue of its size, it was immobile. This "old capital" was then much like a caterpillar on a large spring leaf, fat and happy, maybe a little sassy.

In the mid-nineteenth century, when capital was growing rapidly in power and size and was so visible and immobile, Karl Marx's vision should have surprised no one: that workers would rise up, appropriate the capital, and enlarge the state. Capital could not, in the short-run, easily be moved in response to abuse or appropriation. With the industrialization of the capital base continuing through much of this century, it should also have been no surprise that John Kenneth Galbraith would argue with confidence that government should and could become a "countervailing power" against big businesses within the "new industrial state."

Historically, old capital was very real and tangible, separate and distinct from the owners who managed it and the workers who operated it. This was a circumstance ripe for class conflict, which manifested itself in management-union struggles, as well as in the demagogues' rhetoric of class conflict.

Similarly, the immobility of capital made governments powers unto themselves. Much like business monopolies, governments did not have to worry much about what other governments were charging in the way of taxes and regulations for the right to operate in their jurisdictions. The presumed monopoly power of governments afforded policymakers the opportunity to try out their fondest designs to reconstruct and improve society from the seats of government power. The rewards to those who benefited from the policies could be immediate while the cost of the programs might be felt by future generations encumbered by the steady, but slow, depreciation and exodus of the country's capital base. This circumstance allowed government to expand, since politicians could often escape accountability for negative economic results of their programs.

"New Capital"

Factories made of steel and concrete still dot the landscape, but their economic dominance seems more a feature of the underdeveloped, or rather mis-developed, economies of Eastern Europe than of the Western World. The caterpillar has turned into a butterfly: that is, capital has become more like a butterfly—flighty and elusive, much more capable of evading the grip of governments, and the charges they may try to exact.

The "new capital" has become progressively more mobile. Factories have been downsized. Equipment has been miniaturized at the same time it has been made more productive. Consider, for example, the greater amount of capital that has been packed progressively tighter on thumbnail-size computer chips. The decreasing size and the increasing power of capital and the declining cost of transportation have combined to make modern capital far more fugitive, less captive, than it was just a few years ago.

Furthermore, the critical assets of companies are no longer steel or buildings. They are more often than not the information and the brainpower at the companies' disposal for creating the quintessential company asset—good ideas for doing things better, faster, cheaper, and more profitably at the most favorable location on earth.

Physical location no longer carries the economic value it once did. Business can be, and is, conducted on a global scale, with rapidly decreasing concern and respect for national borders. It is no overstatement to say that quicksilver capital has united, and integrated, the work forces of the world to an extent never imagined by Marx, but with consequences for government power diametrically opposite to the ones Marx

and his followers expected. Geography no longer defines national economies, a fact that has politicians befuddled. The complexity of economic activity, which politicians seek to influence, has been vastly increased.

The critical assets of companies are no longer steel or buildings. They are the information and brainpower that create good ideas.

Government Policies in a Quicksilver World

Leaders of advanced democratic countries have always been concerned about the political consequences of their fiscal and regulatory decisions. After all, they can be turned out of office. However, they now have a new concern, grounded on the economic consequences of the policies they adopt.

Much modern capital is fully capable of moving away from countries that impose unnecessarily onerous policies. This new quicksilver capital has forged a closer linkage between the touted benefits of government policies and their economic consequences.

In effect, greater capital mobility has made governments into competitors, and governments are being constrained by competitive forces in much the same way (although not to the same extent) that businesses are constrained. Elected officials must now fear that if they raise their "tax-prices" or even fail to lower them, or resist improving the quality of their services, then businesses can go to more hospitable jurisdictions, removing the tax base that is the public sector's life blood.

Five Lessons of International Competition

In the 1950s and 1960s many American firms and their workers grew comfortable with their dominant commercial positions in domestic and world markets. Many firms were able to judge their performance by internal standards. Wage hikes totally out of line with productivity increases could be passed through in higher prices. Faulty products could be passed on to consumers who had little basis to judge what was possible other than by what was available from domestic sources.

The coming of the global economy changed all that. Capital, resources, people, and goods became far more mobile, and they began to move. The expansion of trade outstripped the expansion of domestic economies, which were rising relatively more rapidly in Europe and the Pacific Rim countries than in the United States. Capital began moving around the world even more rapidly than trade. Competition began springing from almost all points on the globe, and it intensified.

American businesses were taught important lessons in the process of learning to compete. The first lesson taught by the coming of the global economy is that the market power which was once almost guaranteed to domestic business and worker groups has been dissipated.

The second lesson is that Americans can compete when pressed to do so. Not all firms have been able to meet the competition, as evident by the closure of many steel, textile, and shoe factories. Even in these industries, however, some have met world standards of performance, price, and quality. Consider, for example, the great success of Nucor Steel, Milliken Textiles, and Timberlake Shoes.

The third lesson is that firm or domestic standards of performance are no longer relevant; world standards are now the test. Wage costs not justified by productivity increases can no longer be easily passed through in higher prices. Product quality can no longer be measured against a U.S. yardstick.

The fourth lesson is that firms must be global customers as well as producers. They must seek out the lowest cost suppliers from around the world, or else they will have to concede a part of their domestic and international markets to competitors who do make the search.

And the fifth lesson is that size no longer guarantees continued success. Indeed, large size may be a burden in a world in which flexibility carries a premium.

Competing Visions

Many observers have recognized that current technological trends have created a global market. However, some critics—especially in the United States—have assessed the consequences and policy implications of these trends in a discouraging light. They have charged that these developments need to be opposed by new, innovative government policies—"industrial policies"—designed to "pick winners" and "ease the pain of losers."

Global economic trends, however, have undermined the very capacity of government to do what these policy reformers recommend. The relevant challenge is to shift resources away from political control and into the productive sectors of the economy through tax reform, deregulation, and reduced tariffs.

The remarkable acceleration of capital mobility and the consequent rise of competitive business and government is uncomfortable for individuals in the private and public sectors. Ultimately, however, quicksilver capital promises freedom and opportunity to individuals everywhere. The global economy presents new challenges, but therein lies future growth.

Richard McKenzie and Dwight Lee, both adjunct fellows at the Center for the Study of American Business, are authors of Quicksilver Capital: How the Rapid Movement of Wealth Has Changed the World (Free Press, 1991), from which this article is drawn. Dr. McKenzie is Walter B. Gerken Professor of Enterprise and Society at the University of California, Irvine; Dr. Lee is Bernard Ramsey Professor of Economics at the University of Georgia, Athens.

Poland: The First 1,000 Days and Beyond

by Janusz A. Ordover

Poland has just completed the first 1,000 days of its path-breaking Economic Transformation Program from a planned to a market economy. Now is a useful time to ask, how successful has the reform program been, and what are the prospects for the Polish economy?

With the economy on the brink of catastrophe when the Solidarity Government took power at the end of 1989, it devised a "shock treatment" to stop hyperinflation and remove the severe microeconomic distortions that plagued the economy. Fiscal and monetary policies were tightened, controls were imposed on wages and bank credit, the zloty was linked to the dollar, almost all prices were liberalized, subsidies to state-owned enterprises were removed, and preferential treatment of the public sector was ended.

The economy responded quickly to the stabilization measures: month-on-month price inflation fell quickly from about 80 percent to less than 10 percent. Price liberalization extinguished the endless queues of Polish daily life. Exports and imports grew rapidly.

Unfortunately, GDP itself declined by about 12 percent over the course of 1990, and the sales of the industrial state-owned enterprises plummeted by 30 percent. Real wages, which were already falling in 1989, registered an additional drop early in 1990 to about 70 percent of the December 1989 level, though they soon started to rise again.

Despite the fact that the shock therapy seemed initially to be working reasonably well, the state-owned enterprises failed to adjust quickly to the new market environment. They were slow to shed workers and otherwise cut costs, and many firms barely staved off bankruptcy. Instead, they cut output, which became a major problem for the Polish economy. In addition, budgetary problems and labor unrest took center stage. And among the people there was a growing disenchantment with market reforms.

The state-owned enterprises failed to adjust quickly. They were slow to shed workers. Many firms barely staved off bankruptcy.

All these problems were exacerbated in 1991. Output continued to fall—GDP fell by another 7 percent and unemployment climbed to 11.8 percent. Nevertheless, inflation persisted at a rate of 60 percent per year. Thus, the government faced a difficult (if familiar) dilemma—how to stimulate the faltering economy without exacerbating inflation and the fiscal deficit, which was estimated to exceed 5 percent of GDP by 1992.

New government leaders took office in early 1992 and worked out a provisional agreement to renew Poland's access to IMF's funds, on the condition that the deficit did not exceed 5 percent of GDP. To re-establish control over the budget, highly unpopular measures were instituted to reduce social welfare expenditures further and to restrain growth in public pensions.

Privatization of state-owned enterprises—another key element of the transformation to a market economy—progressed much more slowly than initially intended. The first round of "mass privatization" was scaled back to include fewer and fewer state-owned enterprises—down from an initial goal of a thousand businesses or more (out of 8,000-plus) to only 200 enterprises today.

Looking Ahead

So, where is Poland now and what are the forecasts for the near future? Politically, the situation has stabilized, at least for the time being. The economic situation is also showing some welcome bright spots. The best news is that Poland has now enjoyed almost six months of sustained growth in output, suggesting that the worst of the recession may be over. Price inflation, at only 22.4 percent for the first six months of 1992, has been kept in (relative) check. Exports are also performing well.

The private sector is again growing. The number of private firms increased from about 12,000 in 1989 to 51,000 by 1992. Including unincorporated firms, there are now 1.5 million enterprises controlled by individuals. The private sector now accounts for 27 percent of total industrial output, 80 percent of retail trade and agriculture, over 60 percent of road transport, construction and import trade, and 25 percent of exports. Eighty percent of trucks are in private hands. These are impressive numbers.

Unfortunately, only about 1,100 of the large state-owned enterprises have so far been privatized. Plans for a "mass privatization" are now being completed and should get under way in the fall of 1992. This will entail some 600 major state-owned enterprises that will be allocated in several stages among 15-20 yet-to-be-created National Investment Funds, which will be owned by all eligible Poles. The Polish plan differs from those adopted in Czechoslovakia and Russia in that it eschews direct distribu-

(continued on page 7)

Industry Outlook Report

Overview: Decisively Ambivalent

Edgar R. Fiedler
The Conference Board

The outlook presented by our industry specialists this month is even more neutral than the three reports published earlier this year. The business cycle expectations of our panel simply offer no excitement at all, either up or down. All of them still call for economic growth, but at an even slower pace than the earlier groups had forecast. Indeed, as our small business specialist reports, we have an economy that is expanding, "but not fast enough to keep up with our capacity to grow, much less to re-employ idle labor and capital."

The range of expectations among our panelists is surprisingly narrow. Industries that are slightly more upbeat than average are housing, where, although subdued, "the market for 1993 shapes up to be the best in more than four years," and freight transportation, which "should gradually gain momentum." At the more cautious end of the scale is the aerospace industry, where outlays for military aircraft continue to decline and the airlines are both canceling orders for new planes and stretching out future delivery schedules. In between are electronics, minerals, and small business, which are looking for extremely slow gains in the year ahead. Electronics, with a projected global advance of 5-6 percent for 1993, is achieving growth that most industries would envy intensely, but in this industry, 5-6 percent is regarded as anemic.

Health care is the major exception to the mundane pattern, and it is as much of an enigma as ever. Despite its size, it is growing rapidly. Normally this would be a reason for optimism, but not in health care. Costs are rising too rapidly, too many Americans are uninsured, and all proposed policy responses to these problems promise to create more difficulties than they fix. Everything about the industry is an open road to frustration.

Elsewhere, prices and costs are under tight control, and none of our specialists is projecting any major change in that condition. This encouraging evidence about the inflation outlook is the one unadulterated dose of optimism in the report.

The theme of the report is best summarized by our small business specialist, who reports that executives are "firmly positioned just about halfway between expansion and recession. They are, in other words, decisively ambivalent."

Small Business: All Dressed Up but Nowhere to Go

William C. Dunkelberg
Chief Economist
National Federation of Independent Business

Based on the regular monthly survey of our members, the optimism of small business executives gained a point in August. Twenty eight percent of the firms expect the economy to improve, and only 14 percent expect it to worsen by year end. Thus the group is firmly positioned just about halfway between expansion and recession levels. They are, in other words, decisively ambivalent.

The unpleasant message here is that the economy is expanding, but not fast enough to keep up with our capacity to grow, much less to re-employ idle labor and capital. Sales trends are also improving and the number of firms reporting profit gains continues to rise as well.

There are two bright spots in the outlook. First, the inflation outlook is excellent, with only 16 percent of the respondents—a record low—planning to raise prices over the next 6 months.

Inventory Position
as reported by National Federation of Independent Business

Second, inventories are at their leanest levels in the history of the NFIB surveys—since 1973. Indeed, inventories have not been a problem at any time in this recession. In the mid-1980s, after only 4 years of expansion, more firms thought the economy would slow than expected it to grow, and they began managing their stocks for a downturn. Years later, when the business cycle finally did turn down, most firms were well positioned to weather the storm.

In August, 8 percent of all firms reported inventories "too high," but 12 percent reported inventories "too low." As the chart shows, this represents a record LEAN position—it was only matched once previously, prior to the major inventory correction of 1974. At that time, firms were hoarding inventories, in contrast to the present situation when stocks of inventories are numerically low and very low relative to sales. The only thing lower is the stock of customers!

Prospects for growth are excellent; unfortunately, it's very sluggish growth. Furthermore, it's likely to be with us for awhile as the economy continues to heal and position itself for more controlled and solid growth in the future.

Electronics: Uninspiring Growth

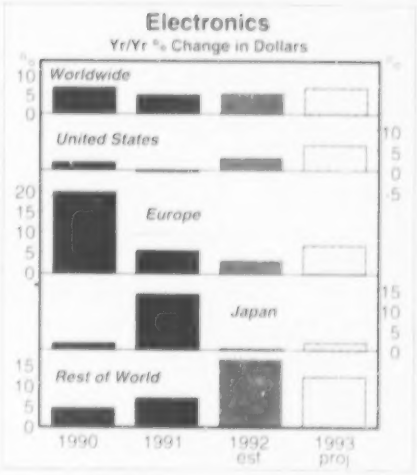
Richard O'Brien
Hewlett-Packard

The 1992 world electronics market will be worth $850 billion. This 5-6 percent growth in the electronics equipment market represents the third year of anemic performance. The U.S. outlook has brightened, but not much. Demand for computer and communications equipment is better than expected. Military electronics, however, continues on the downside.

Overall, the U.S. electronics market is growing at 3 percent. The European market is weak, with the German market being the major culprit. The weakness of the dollar against the European currencies, particularly the German mark, has masked the weakness of these markets in local currencies. In dollar terms, however, the European market will grow at about 3 percent. The Japanese market for electronic equipment is in a slump, undercut by the soft economy. The yen-denominated value of equipment will fall. However, due to the weakness of the dollar, the Japanese market will be flat in dollar terms.

As the industry heads into 1993, electronic equipment will generally parallel capital equipment spending. Decreases in the prices of computers and related equipment will continue to have significant negative impact on revenue growth, while defense spending continues to be weak. Components, benefiting from the increasing semiconductor content of electronics products, lead the upturn.

The U.S. electronics industry is likely to experience stronger but not robust growth of 6 percent as the U.S. economy recovers. The European market is slated to stage a slow, 7 percent recovery, but one must wait until 1994 before health returns. It is now abundantly clear that the Japanese market will not be vibrant next year; the market is expected to grow a mere 2 percent. Markets in the rest of the world, particularly Asia, remain the bright spots with double-digit growth rates.



Minerals: Storm Clouds Postpone Recovery

John D.S. Macleod
C R A Limited
(Australia)

New storm clouds have blown up over the world economic outlook. Turmoil in the European currency and interest rate markets combined with slow growth in Japan and a feeble U.S. recovery mean that world economic growth in the second half of 1992 and first half of 1993 will be weak. At best we are now talking about stronger growth in the second half of 1993.

The meager level of world economic growth appears to be insufficient to raise metal demand and hence metal prices significantly above their present depressed levels. A world growth of 2 1/2 - 3 percent is needed to boost demand and this seems at least 12 months away.

There are a number of other forces to be considered. First, the build-up of inventories during the recession: Aluminum inventories, for example, currently stand at about 16 weeks consumption, not an unusual level for this stage of the cycle but nevertheless large enough to constrain early price increases. Second, East Europe/CIS, where a desperate need for foreign currency has resulted in sales of metals into Western markets, thereby depressing prices.

Is there any good news in this generally bleak picture? The answer is "yes", but it's hardly front-page news. In Asia metal demand continues to grow very strongly. The bigger markets are in North Asia but South Asia is now beginning to grow too. In China and, to a lesser extent, India, major potential exists and the consumption of steel, aluminum, copper, etc., has surged over the past year.

The slow growth worldwide means that metal producers are facing a profit squeeze. Most are reducing costs to ensure they are internationally competitive. Exploration and R&D efforts look promising. The importance of exploration cannot be over-emphasized, since all ore-bodies have a finite life and many were developed back in the 1960s. In addition a number of processing plants are quite old and, with poor profit experiences over a long period (e.g. steel), investors are cautious about building new facilities.

Finally, the industry remains plagued by developmental delays. Access to land, environmental constraints and other difficulties could imply supply shortages later in the decade.

Health Care: No Magic Bullet

Jack Meyer
New Directions for Policy

The U.S. health care system is rapidly approaching $1 trillion of total expenditures. Ironically, even as total spending soars, about one of seven Americans has no health insurance, and millions more are underinsured.

Another paradox in health care is the combination of underspending on preventive medicine and basic primary care and mounting evidence of unnecessary care in the form of excessive diagnostic tests and inappropriate surgery.

We forecast total health expenditures of $832 billion in 1992. Next year, total spending should be in the range of $926 billion, and it is almost certain to reach or top $1 trillion in 1994 (see table).

Sharply rising health care costs are adding to the pressure on government budgets and employers' labor costs. Medicare is likely to run out of money in the early part of the next century. Medicaid costs have nearly doubled in the last three years. And business contributions for health care are increasing at double-digit rates annually.

There is no quick fix or magic bullet to end these problems. The forces driving up health care costs, including technological development, economic growth, behavior and lifestyle, and the organization of our health care system, are not easily altered. Furthermore, to be successful in denting the long-term growth of expenditures on health care, a new policy will have to place constraints on either the free choice of providers, access to advanced medical technology, or both.

We face two basic policy choices. First, we must decide whether to finance an extension of coverage to the uninsured primarily through government subsidies or through a more regressive, "off-budget" tax on business. Second, to contain costs we must decide whether to use incentives or controls. Using incentives is more likely to encourage innovation and promote high-quality care. Government controls, however, are more likely to bring short-term relief, albeit at the expense of some queuing and stifling of innovation.

Projected Growth of Health Care Expenditures

(billions of dollars)

	1992	1993	1994
Total Health Care Expenditures	832	926	1030
Medicare Outlays	131	139	166
Medicaid Outlays	124	143	169
Employer Health Insurance Premiums	167	220	253

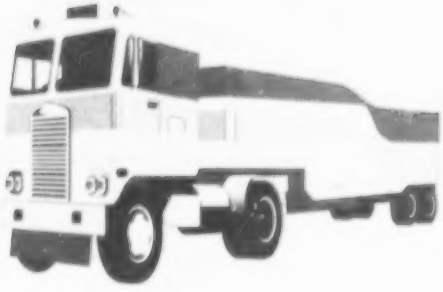
Estimates by New Directions for Policy, Washington, DC.
Source: Health Care Financing Administration projections.

Freight Transportation: Gradually Gaining Momentum

Raymond J. Sweeney
Merrill Lynch Capital Markets

Following 1991 losses that ranged from painful to catastrophic, all freight modes have shown some improvement in 1992. In particular, trucking showed an 8 percent increase in operating revenues and a rise in profit margin from a measly 1.3 percent in the first half of 1991 to a slightly healthier (though still inadequate) 2.2 percent in the first half of 1992.

All modes of freight transportation, however, continue to experience overcapacity, which, along with a generally low rate of inflation, is acting to hold down prices. Industrial production, a commonly used gauge of demand for freight services, has risen by less than 2 percent during the first three quarters of 1992. Even with an increase in the number of firms exiting the industry, there is not enough freight to go around. Survivors have been squeezing costs hard, by eliminating jobs (notably among railroads) and installing productivity-enhancing communications systems, routing and other software, and electronic data interchange with customers. All modes have been spared a repeat of the devastating fuel-price increases of 1990.



All of these trends are expected to continue over the next 18 months. Industrial production, and hence freight volumes, should gradually gain momentum. Fuel, labor and other costs will rise slowly if at all, allowing for moderate improvement in profits.

Housing: Continued Modest Improvement

David W. Hale
Economist

The housing market has taken its usual role of recovering more quickly than most other parts of the economy. Housing starts are expected to rise almost 20 percent this year, while new home sales should be up by slightly more and existing home sales should increase by about 9 percent. All three markets were well on their way to these gains in late September.

Despite these seemingly strong increases, however, this housing recovery has been more subdued than usual—mirroring the national recovery. The lowest mortgage rates, and highest levels of affordability, in nearly 20 years have had a positive impact on the housing market, but slow economic growth and weak consumer confidence—stemming from a stagnant labor market—have held down the housing recovery.

The most recent forward-looking indicators of the housing market, the monthly survey of builders from the National Association of Home Builders and the weekly survey of mortgage applications from the Mortgage Bankers Association, both indicate that the housing market is poised for renewed growth. The strength of this additional recovery will, however, depend on mortgage rates remaining relatively low and—even more important—on improving labor markets. If employment growth remains sluggish, then poor consumer confidence will prevent low levels of mortgage rates from fully translating into stronger home sales and construction.

With only a modest pickup in the economy next year, we expect housing starts to rise by almost 9 percent. The legacy of tax-induced overbuilding in the 1980s will continue to haunt the multifamily sector, however, keeping multifamily housing starts at depressed levels. New home sales should respond to still-low mortgage rates and moderately better labor markets with a gain of about 11 percent, with existing home sales up by more than 7 percent. As a result of these increases, the housing market for 1993 shapes up to be the best in more than four years, although the recovery will remain more subdued than usual.

The Housing Market

(millions of units)

	1991	1992	1993
Housing Starts	1.01	1.21	1.31
New Home Sales	0.51	0.61	0.67
Existing Home Sales	3.52	3.81	4.07

Aerospace: The Watchword is Caution

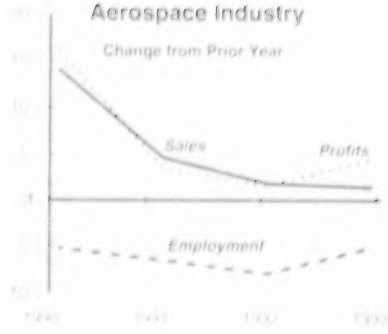
L. Ramsey Lein
Vice President, Economic Consultant

Near term, the watchword for the aerospace industry is caution. Growth in the industry has temporarily (we hope!) stalled as the commercial transport segment responds to an adverse global economic environment. New aircraft orders have slowed as carriers have canceled orders and stretched out delivery schedules. The civil transport aircraft backlog at the end of 1991 stood at 2,781 planes worldwide, a decline of 12 percent from a year earlier. This segment should rebound as the economic climate improves, especially since many carriers need to replace older aircraft in their fleets.

The industry's defense segment continues to decline, a trend that will continue as long as no new threat to international stability emerges. New development programs are giving way to upgrades and extensions of existing weapon systems. A defense spending "floor" will eventually be reached, but budgets seem headed for levels akin to post-World-War-II and post-Vietnam lows. Aerospace industry employment is projected to decline from a 1989 peak of 1,331,000 to 1,086,000 by the end of 1992.

The space segment is projected to continue to grow, but at a decreasing rate. Funding for Space Station Freedom remains vulnerable to the threat of cancelation from Congress. General aviation deliveries have been in decline since 1989, but business aircraft sales are projected to grow once an economic recovery gets under way.

In the future, smaller, leaner, and fewer aerospace firms will look for commercial market recovery, teaming opportunities, globally oriented strategies, and new technology applications. Margins will begin to improve as companies become more streamlined and the defense portion of the industry puts behind it the now discredited firm-fixed-price-development contracts of the late 1980s. Defense and space projects will compete in our political process with national infrastructure improvement and social benefit programs. International sales will face the same pressures, as other nations make similar defense cuts. Worldwide economic recovery will have the biggest positive effect on industry sales and profits.



tion of "vouchers" that can be used to purchase shares in privatized enterprises. In Poland, the concern is that a direct voucher scheme would lead to such diffused ownership of enterprises that managers will be left without effective control.

To re-establish control over the budget, highly unpopular measures were instituted to reduce social welfare expenditures further and to restrain growth in public pensions.

Many serious economic problems still persist. Although recently improved, concerns remain about the unsettled labor situation; these concerns are delaying badly needed foreign investments in some of Poland's more antiquated industries. Lack of clearly defined property rights, inadequate bankruptcy law, poorly developed labor and housing markets, bureaucratic red tape, and concerns about liabilities for environmental damages from existing state-owned enterprises have further deterred foreign capital. Importantly, however, many major corporations are pressing on: Levi Strauss, International Paper, Coca Cola, ABB, Fiat, and CPC have all made major investments in Poland. Moreover, it now appears that Poland will be able to renegotiate access to the IMF's short-term loan facility.

If the government can maintain a tight wage policy and keep the lid on the budgetary deficit over the next six months, Poland's prospects may be better than at any time in the last 18 months. This will require that social spending, now 21 percent of GNP compared with 11 percent in 1989, be reduced, and that revenues, now about 25 percent of GNP, be increased. Such macro-economic discipline will not be easy since the finances of state-owned enterprises are increasingly desperate, many social expenditures have already been slashed, and alternative sources of tax revenues (such as the VAT) are not yet in place. This summer's catastrophic drought has added to the already precarious economic situation.

In sum, the economic situation remains precarious and the odds are probably less than even that Poland will dig itself out of recession any time soon.

Janusz A. Ordover is Deputy Assistant Attorney General for Economics, Antitrust Division, U.S. Department of Justice, and Professor of Economics, New York University (on leave). He was formerly an advisor to the Polish Ministry of Finance and the Anti-Monopoly Office. The views expressed here are solely those of the author.

The World Bank's Recommendations for Privatizing State Enterprises

The more market-friendly a country's policy framework, the less difficult it will have in privatizing a state enterprise, and the higher the likelihood that the sale will turn out positively.

State enterprises functioning in competitive markets, or in markets easily made competitive, are prime candidates for privatization. Their sale is simple, compared to public monopolies, and they require little or no regulation.

Before privatizing monopolies, appropriate regulations must be in place. Failure to regulate properly can hurt consumers and reduce public support for privatization.

The primary objective of privatization should be to increase efficiency—not to maximize revenue (for example, by selling into protected markets), nor even to distribute ownership widely at the expense of efficiency.

Countries can benefit from privatizing management through management contracts, leases, contracting out or concessions.

Rather than restrict the market by excluding foreign investors and favoring certain ethnic groups, experiment with "golden shares" and partial share offerings to win acceptance for foreign and other buyers.

Experience shows that labor does not, and need not, lose in privatization, if governments pay attention to easing the social cost of unemployment through adequate severance pay, unemployment benefits, retraining and job search assistance.

Avoid large new investments in privatization candidates; the risks usually outweigh the rewards. Instead prepare for sale with financial workouts, with labor shedding, and with legal, managerial and organizational changes.

Ideally, let the market set the price and sell for cash. Realistically, negotiated settlements and financing arrangements or debt/equity swaps may be unavoidable.

In all privatizations, in all countries, the transaction must be transparent.

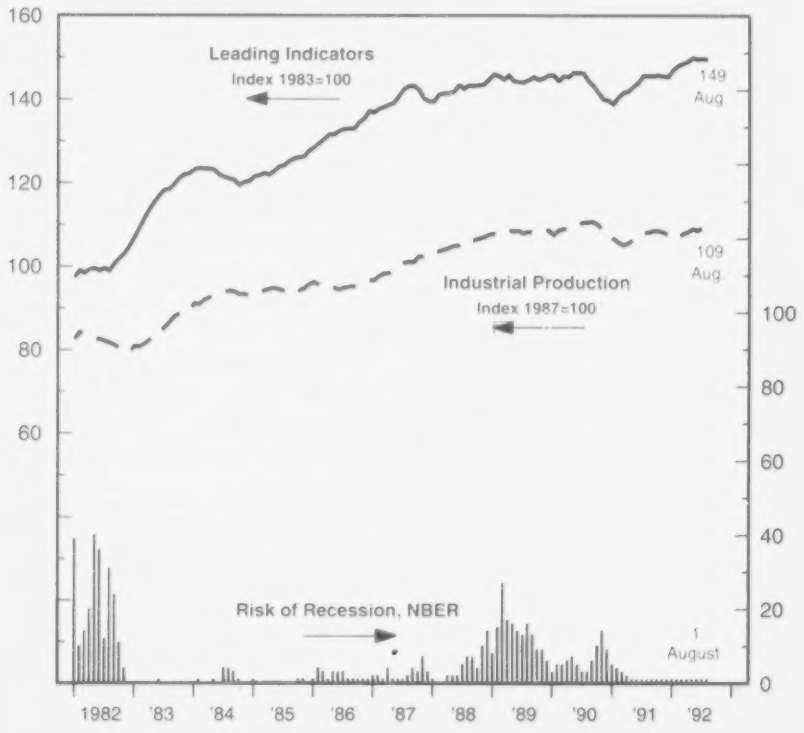
Source: "Privatization: The Lessons of Experience," The World Bank, 1992.

Conference Board Stat File

But End It Will

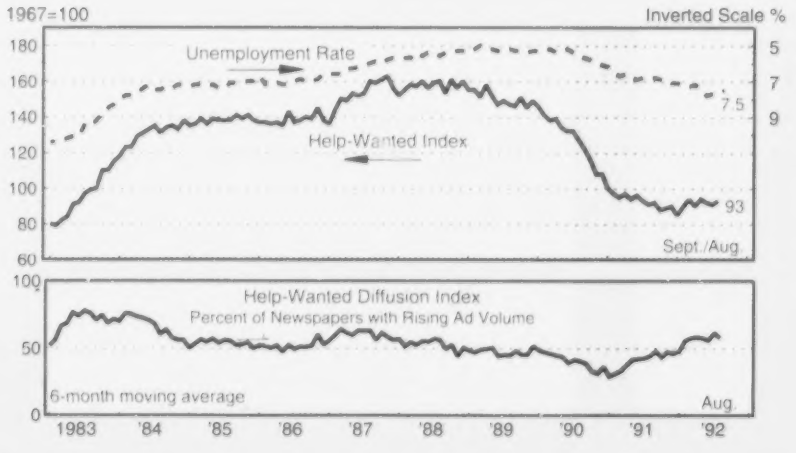
It's difficult to recall when the business cycle was quite so torpid as it is now. The table borrowed from Maureen Allyn (Exhibit of the Month, p. 10) illustrates this nicely: For every sector adding energy to the system, there is another acting as a brake. It's an extremely frustrating economy, not generating enough expansion to re-employ the idle workers and plants, but also not displaying enough weakness to compell more dramatic policy action. What will trigger an acceleration of the cyclical recovery, sooner or later? Perhaps a new departure of fiscal or monetary policy, perhaps natural forces such as revived consumer sentiment, the need to rebuild depleted inventories, improved profitability spurring new investment, and the like. At present there's nothing in sight to suggest this wallowing in the doldrums will end soon. But end it will. *(Note: Data for Conference Board series in this section are available on request from Ken Goldstein at 212-339-0331.)*

Early Warning Indicators



Business cycle upswing struggles forward.

Help-Wanted Advertising and Unemployment



Labor demand improving marginally, but still very weak.

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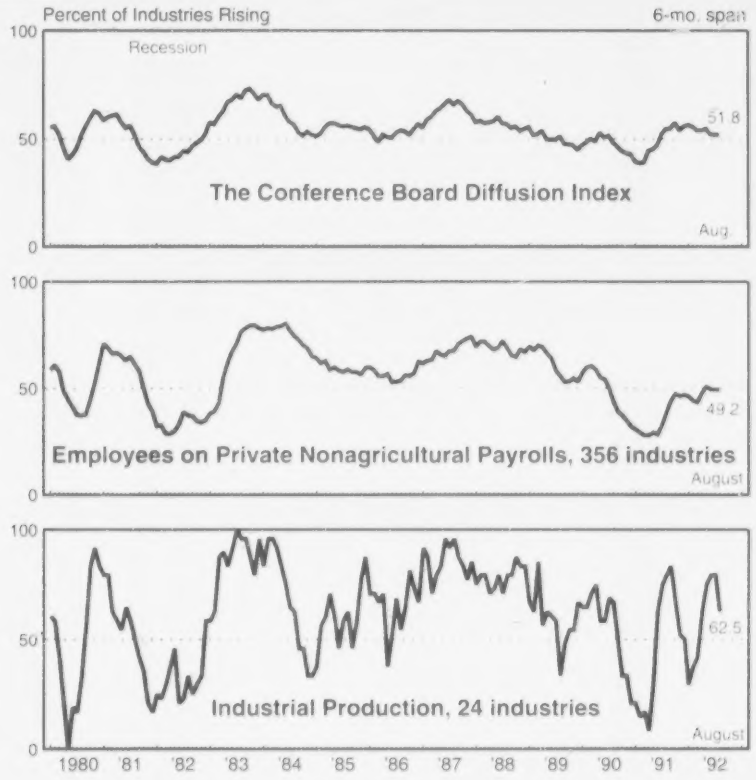
Indexes of Economic Momentum

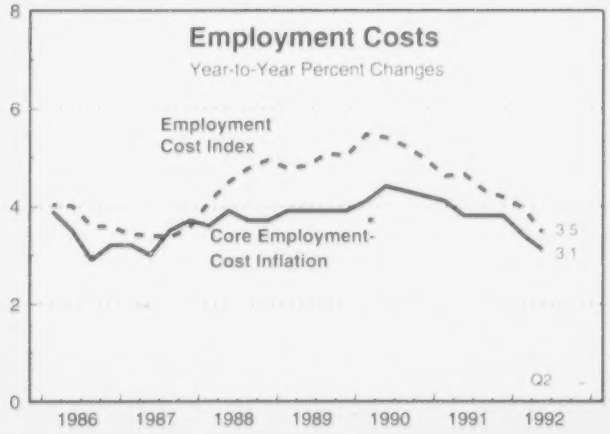


No momentum, either up or down.

Core inflation continues to improve.

Inflation Fundamentals

* Core Inflation = CPI excluding food at home and energy



* Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e., excluding the benefits that are part of the ECI).

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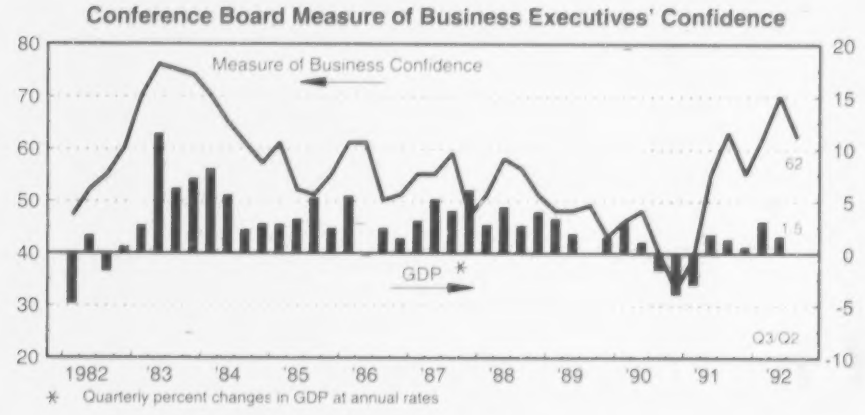
Confidence



* Quarterly percent changes in GDP at annual rates

Consumer confidence drops still another notch.

Exhibit of the Month

The U.S. Economy: Macho Man or Wimp?

Strengths	Weaknesses
• Inflation slow	• Debt loads high
• Balance sheets improving	• Borrowing cautious
• Short-term interest rates low	• Real long-term interest rates high
• Capital spending rising	• Consumer spending languishing
• Profits rebounding	• Wage gains modest
• Productivity rising	• Unemployment high, job growth slow
• Single family starts climbing	• Offices and apartments overbuilt
• Inventories lean	• Federal deficit still bloated
• Exports highly competitive	• Defense outlays falling fast

Conclusion: Yes it is, Isn't it?

Source: Maureen Allyn, Chief Economist, Scudder Stevens and Clark

Inside the Crystal Ball

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	NORTHERN TRUST	CONF. BOARD	EATON	L.H. MEYER	DRI	WEFA	MICHIGAN - RSQE		
Date of Forecast		Sept.	Sept.	Sept.	Sept.	Sept.	Sept.	Sept.	Sept.	Sept.	Sept.	Aug.		
Gross Domestic Product		(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)												
		%	%	%	%	%	%	%	%	%	%	%		
Actual	1992 1Q	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	1Q 1992	Actual
	2Q	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.4	2Q	
Forecast	3Q	0.7	1.5	1.3	1.1	2.0	1.3	1.8	1.6	1.7	1.6	1.3	3Q	Forecast
	4Q	1.8	1.6	1.9	2.5	2.9	1.6	3.1	2.1	2.9	2.7	3.1	4Q	
	1993 1Q	2.0	1.8	3.2	3.2	3.1	1.7	4.1	2.7	2.9	3.0	3.9	1Q 1993	
	2Q	2.8	2.6	3.8	2.8	3.1	2.7	4.1	2.9	3.5	3.2	3.6	2Q	
	3Q	3.5	2.8	3.8	2.8	3.0	2.4	3.6	3.3	3.1	2.9	3.1	3Q	
	4Q	3.5	3.0	3.7	2.2	2.8	2.1	2.6	3.1	3.3	2.7	2.6	4Q	
	1994 1Q	3.6		3.6	2.1		1.7	3.0	3.1	3.1	2.9	2.7	1Q 1994	
	2Q	2.6		3.6			1.9	1.4	3.1	2.9	2.8	2.6	2Q	
	3Q	2.2		3.7			1.9	2.0	2.8	2.1	2.8	2.4	3Q	
Inflation (Deflator)		(Percent change from same quarter one year earlier)												
Actual	1991 4Q	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	1991 4Q	Actual
Forecast	1992 4Q	3.6	3.4	3.7	3.6	3.8	3.8	3.4	3.6	3.2	3.5	3.2	1992 4Q	Forecast
	1993 4Q	2.7	3.0	3.1	3.2	3.0	3.5	3.0	2.3	2.8	2.7	2.4	1993 4Q	
30-Yr Treasury Bond Rate		(Percent, quarterly)												
Actual	1992 1Q	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9	1Q 1992	Actual
	2Q	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9	7.9	2Q	
Forecast	3Q	7.4	7.4	7.5	7.4	7.5	7.4	7.4	7.4	7.5	7.5	7.5	3Q	Forecast
	4Q	7.2	7.3	7.3	7.4	7.4	7.5	7.1	7.2	7.4	7.4	7.4	4Q	
	1993 1Q	7.3	7.4	7.4	7.4	7.3	7.7	7.2	6.9	7.3	7.5	7.4	1Q 1993	
	2Q	7.3	7.7	7.6	7.6	7.3	7.8	7.2	6.7	7.3	7.5	7.4	2Q	
	3Q	7.4	7.8	7.8	7.7	7.3	7.9	7.2	6.6	7.3	7.6	7.4	3Q	
	4Q	7.5	7.9	7.9	7.9	7.4	8.0	7.2	6.5	7.4	7.7	7.3	4Q	
	1994 1Q	7.5		8.0	8.1	7.4	8.0	7.2	6.3	7.5	7.8	7.2	1Q 1994	
	2Q	7.5		8.0		7.5	8.1	7.0	6.2	7.6	7.9	7.2	2Q	
	3Q	7.6		8.0			8.1	7.0	6.1	7.5	8.0	7.2	3Q	
Unemployment Rate		(Percent, quarterly)												
Actual	1991 4Q	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	4Q 1991	Actual
Forecast	1992 4Q	7.7	7.7	7.6	7.5	7.5	7.8	7.6	7.7	7.6	7.6	7.6	4Q 1992	Forecast
	1993 4Q	7.0	7.0	6.9	7.1	7.0	7.7	7.0	7.1	6.9	7.0	7.0	4Q 1993	
	1994 3Q	6.6		6.3			7.6	6.4	6.5	6.4	6.6	6.8	1Q 1994	

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